Applicability

Accounting Standard 2 – Valuation of inventories is a measurement standard having far reaching implications on the financial statements. AS 2 is applicable to all enterprises, irrespective of the size and nature of business.

Though, by number it is two, the AS 2 (revised) is applicable to all enterprises wef 1-4-99 only. The earlier AS 2 was not mandatory in nature.

Issue 1:

Which assets are specifically excluded from the scope of AS 2, Valuation of Inventories?

☞ AS 2, does not encompass inventory valuation for the following:
   (a) Work-in-progress arising under construction contracts (AS 7);
   (b) Work-in-progress arising in the ordinary course of business of service providers;
   (c) Shares, debentures and other financial instruments held as stock-in-trade, and
   (d) Producer’s inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

Issue 2:

Will AS 2 apply to valuation of inventories in case of service providers?

☞ Reference to service providers appears at two places in AS 2. At one place, it mentions AS 2 will not apply to work-in-progress arising in ordinary course of business of service providers. At other place it mentions, Inventories are assets in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Thus, an anomaly is created where in AS 2 is not explicit as to its applicability to service providers. Under such context, service providers depending upon the nature of contract will be either governed by AS 9 ‘Revenue Recognition’ or AS 7 ‘Accounting for construction contracts’.

Issue 3:

A Ltd., has purchased spare worth Rs. 100 lakhs to be used as a machinery spare in connection with a particular fixed asset. Keeping of such spare is very critical for A Ltd, else production would get hampered. Is A Ltd required to value such spare under AS 2? If not, how should accounting for such spare be made in A Ltd’s financial statement?

☞ AS 2 Categorically mentions that Inventories donot include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular. Such machinery spares are accounted for in accordance with AS 10, Accounting for Fixed Assets.

Such spares can be termed as insurance spare or critical spare. AS 10 states, if such spares can be used in connection with an item of Fixed Asset and their use is expected to be irregular, it may be appropriate to allocate the total cost in a systematic basis over a period not exceeding the useful life of the principal item. Thus, such spare are normally capitalised as part of fixed asset and depreciated over the useful life of the fixed asset, even though not consumed.
Issue 4:

Inventory valuation should be done on principles of Direct Costing or Absorption costing? Further, in case of absorption costing, how is the fixed production overhead allocated?

Revised AS 2, now stipulates only one method and that is Absorption costing. Absorption costing will include direct labour, and a systematic allocation of both fixed and variable production overheads that are incurred in converting material into finished goods. Fixed production overheads include depreciation, maintenance, rent and taxes, cost of factory management and administration.

Fixed production overheads are allocated to each unit of production based on normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used when it approximates normal capacity.

In periods of abnormally high production, there is the risk that inventories are carried at an amount greater than cost if fixed overheads are allocated based on normal capacity. In such circumstances, the use of normal capacity may mean that the total amount of fixed overhead allocated to inventories, both sold and on hand, in the period exceeds the total amount of fixed overhead incurred in the period. Thereafter, the amount of fixed overhead allocated to each unit of production is reduced so that inventories are not measured above cost.

No guidance is given on what is meant by abnormally high production. However, the amount of fixed overheads allocated to inventory, both sold and on hand, will exceed the total amount of fixed overheads incurred in any period in which actual production exceeds normal capacity. Therefore, the issue is really one of materiality, rather than abnormality.

Low production creates the risk that inventories are carried at an amount less than cost. In such cases, however the amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant.

Issue 5:

Acidchem Ltd., a chemical unit manufactures X product which is the main product, whereas product Y is a saleable by – product. Acidchem Ltd. for year end purpose, values X Product at full cost whereas Y product is valued at Rs. NIL. Is costing method adopted by Acidchem Ltd. in consonance with AS 2?

As per AS 2, By-products, waste or scrap materials are measured at net realisable value and this value is deducted from the cost of main product.

Acidchem Ltd., should value by-product Y at net realisable value and the same should be deducted from costing for valuing main product X.

Issue 6:

Sweet Ltd., is engaged in manufacture and sell of Sugar. Sugar being a seasonal product manufacturing is done for four months and product is sold throughout the year. Sweet Ltd. incurs substantial interest cost in holding sugar and at year end wants to include interest as cost of production. Can Sweet Ltd. do so?

As per AS 2, Interest will form part of other cost and such cost are included in the cost of inventories only to the extent that they are incurred in bringing the inventory to their present location and condition. Thus, interest and other borrowing cost are considered as not relating to bringing inventory to their present location and condition. Thus, Borrowing costs are not capitalised on inventories which are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time.

Even as per AS 16, Borrowing Costs, may be included in the cost of inventories which are qualifying assets, that is, those which require a substantial period of time to bring them to a saleable condition e.g. wines and spirits which require time to mature.

Sweet Ltd, irrespective of the magnitude of interest payment, cannot include interest payment incurred on holding inventory i.e. – Sugar as part of inventory cost.
Issue 7:
Aggressive Ltd., has launched a new product in the market in February 2004. Company incurred heavy advertisement expenditure of Rs.10 crores as product launching expenses. The demand is expected to pick up from April 2004. For the year ending March 2004, Aggressive Ltd. wants to include the advertisement cost in the inventory valuation, stating profits from sale of products are to come from April 2004. Can Aggressive Ltd. do so?

☞ AS 2, excludes certain expenses from the cost of inventories and one of them is selling and distribution cost. Thus, Aggressive Ltd. will not be able to include such heavy advertisement expenses as part of inventory cost.

Alternatively, with AS 26 becoming effective from 01-04-2003 and assuming AS 26 applies to Aggressive Ltd., such heavy expenditure will also not fall within the definition of Intangible asset and accordingly such intangible item will have to be written-off in the year of occurrence. Aggressive Ltd. will have to write-off the entire expenditure of Rs. 10 crores in the year 2003-2004.

Issue 8:
With AS 26 gaining significance more so where technology is considered as prime asset, will it be appropriate to include in the cost of inventories, the following:

(a) Cost of designing products for specific customers?
(b) Amortisation of development costs relating to a particular product or process?

Depreciation of a patent or licence relating to a particular product or process?

☞ AS 2 permits other costs to be included in the cost of inventories to the extent that they are incurred in bringing the inventories to their present location and condition. Such above cost which forms part of cost in bringing the inventory to its present location and condition will be allowed to be included as part of inventory cost.

Issue 9:
Big Bite Ltd. is in manufacturing of Biscuits, having six plants over different location in India. At three plants Raw Material and Packing Materials are valued on first in First out basis, whereas at other three plants Raw and Packing Materials are valued on weighted average basis. Is valuation method adopted by Big Bite Ltd. correct?

☞ The question arising for consideration is whether an enterprise can use different cost formula for same type of inventories.

An enterprise should use the same cost formula for all inventories having similar nature and use to the enterprise. A difference in geographical location of inventories and tax rules is not by itself, sufficient to justify the use of different cost formulas. Thus, Big Bite Ltd., which is in manufacture of Biscuits and as the raw and packing materials at all the six plants are having similar nature and use, the company would be advised to adopt one cost formula in valuing Raw and Packing material i.e. either FIFO or Weighted Average Method.

Issue 10:
Import Ltd. purchases 10,000 kg. of inventory for US $1,00,000 on 1-3-04, which is financed by 180 days credit. The rate as on 1-3-04 is say Rs.45 for one US $. On 31-3-04, the US $ rate to rupee is say Rs.43.50, whereas on 27-8-04 the rate is Rs.46.50 per US $. Import Ltd., wants to adjust the exchange fluctuation arising on financing inventory to the cost of inventory. Can Import Ltd. do so?

☞ As per old AS 11 as well as new AS 11 (effective from 1-4-04), any foreign currency transactions involved in the acquisition of inventories are recorded by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. The effect of subsequent changes in the exchange rate on the resulting liability are treated as exchange difference and are not included in the cost of inventories.

Thus, Import Ltd. will have to account for inventory at US $45 being the rate prevailing at date of transaction in its books as cost of purchase. The exchange fluctuation arising on 31-03-04 of Rs.15,00,000 (45 - 43.50 x 1,00,000) will have to be shown as a gain on exchange fluctuation, whereas in 04-05, exchange fluctuation loss of Rs.30,00,000 (43.50 – 46.50 x 1,00,000) will have to be shown in financial statements, with no corresponding effect to inventories in either years.
Issue 11:

Snabisco Ltd. is in manufacture and sale of snacks, biscuits and confectionaries. At year end, Snabisco Ltd. compares the total cost of three products with the total net realisable value of all the three products. If the total net realisable value is lower than the total cost, than it adopts total net realisable value, else inventory is valued at cost. Is inventory valuation method of Snabisco ltd. appropriate?

☞ As per AS 2, carrying amount of inventories should not exceed the net realisable value. Therefore, inventories need to be written down to net realisable value when cost exceeds that value. The need to write-down may also arise when inventories are damaged, wholly or partially obsolete or other wise unsaleable or when their selling prices have declined.

As per AS 2, Inventories are written down to net realisable value on an item by item basis. However, similar or related items may be grouped for practical reasons in some circumstances. In particular, inventories of the same product are grouped when they have similar purposes or end uses, and are produced and marketed in the same geographical area and cannot practicably be evaluated separately from other items in that product line.

It is inappropriate to group all finished goods or all inventories in a particular industry or geographical segment and determine the write-down on a global basis. Therefore, it is inappropriate for Snabisco Ltd. to compare the cost of all inventories i.e. snacks, biscuits and confectionaries with the aggregate selling price of those inventories. Similarly, it is inappropriate for Snabisco to determine the write-down by comparing the cost of all its inventories with their aggregate selling prices.

Snabisco Ltd., should at the most compare the cost and net realisable value of snacks, biscuits and confectionaries independently after taking into consideration individually those inventories which are damaged, wholly or partially obsolete or otherwise unsaleable.

Issue 12:

What are the Disclosure requirements of AS 2, Inventories?

☞ Apart from being a Significant Accounting Standard, governing the preparation and presentation of the financial statement, AS 2 also requires the following disclosures to be made in the accounting policies:

(a) The accounting policies adopted in measuring inventories, including the cost formula used and
(b) The total carrying amount of inventories and its classification appropriate to the enterprise.

Measuring inventories would be cost or net realisable value, where as cost formula would mean first in first out, weighted average cost or in few cases specific identification cost. It must be remembered that National Accounting Standard (NAS) unlike the International accounting standard (IAS) does not permit use of Last in first out (LIFO) basis as one of the cost formula.

Schedule VI to companies Act, 1956 also requires to Disclose total carrying amount of inventories. Appropriate classification is also given in Schedule VI to the companies Act, 1956. AS 2 lists out common classification of inventories as raw material and components, work in progress, finished goods stores and spares and loose tools.

Accounting policies of Select Indian Companies is given here below:

1. Reliance Industries Limited (31-3-04)

Inventories

Items of Inventories are measured at lower of cost or net realisable value. Cost of inventories comprise of all cost of purchase, cost of conversion and other cost incurred in bringing them to their respective present location and condition. Cost of raw materials, process chemicals, stores and spares, packing materials, trading and other products are determined on weighted average basis. By-products are valued at net realisable value. Cost of work-in-progress and finished stock is determined on absorption costing method.
2. Larsen & Toubro Limited (31-3-04)

Inventories

Inventories are valued after providing for obsolescence, as under:

a) Raw materials, components, construction materials, stores, spares and loose tools at weighted average cost.

b) Work-in-progress

   I. Work-in-progress (other than project and construction-related) at cost including related overheads.

   II. Project and Construction-related work-in-progress at cost till a major portion of the job is completed and thereafter at realisable value.

   In the case of qualifying assets, cost includes applicable Borrowing costs vide policy relating to Borrowing Costs.

c) Finished goods at lower of cost or net realisable value. Cost includes related overheads and excise duly paid / payable on such goods.

d) Property Development Land at lower of cost or net realisable value.

3. Tata Iron and Steel Company Limited (31-3-04)

Inventories

Finished and semi-finished products produced and purchased by the company are carried at lower of cost and net realisable value. Purchased goods-in-transit are carried at cost.

Work-in-progress is carried at lower of cost and net realisable value. Coal, iron ore and other raw materials produced and purchased by the Company are carried at lower of cost and net realisable value. Purchased raw material-in-transit are carried at cost.

Stores and spare parts are carried at or below cost. Cost of Inventories is generally ascertained on the weighted average basis. Work-in-progress and finished and semi-finished products are valued on full absorption cost basis.

4. Zee Telefilms Limited (31-3-03)

Inventories

Inventories of Raw Stock (Tapes and Cassettes etc.), Television Programs / Films etc. under Production, Stock in Trade (Television Programs, Films and Rights, Audio Cassettes, Electronic Devices, etc.) are valued at lower of cost or estimated net realizable value as detailed hereunder:

Cost

Cost is taken on First in First Out (FIFO) or Specific identification basis. In case of Films / Television Programs with multiple rights cost is allocated to each right as per management estimate. Cost includes un-amorized cost.

Net Realizable Value

Net realizable value is as estimated by the management on the basis of future revenue generation capacity of the programmes or films. Where the recoverable amount is less than its carrying amount, the programme or film right is written down to its recoverable amount and the impairment loss is recognized as an expense in the Profit and Loss Account.
Costs are amortized/expensed as under:

**Content – Trade**

Television programs / films etc. acquired or produced by the Company for sale

a) Cost of Programs like News, Current Affairs, Chat Shows, Events etc. are fully expensed on its first sale.

b) Programs having re-exploitable value are expensed 90% on first sale and 10% expensed on its subsequent sale;

c) In case of the film produced / acquired by the Company, cost of each right is expensed fully on first sale.

d) Other Programs, Films Rights already sold for limited telecast rights are amortized on realizability review or on use as per (ii) below:

**Content – Broadcasting**

Television programs / films, acquired or produced and used as a broadcaster for telecasting on its own television channels:

i) Cost of programs like news, current affairs, chat shows, Events etc. are fully expensed on first telecast.

   The cost of the program rights (including unamortized cost of content from Trade) are amortized on straight line basis from its first telecast, over 36 months or license period whichever is shorter.

ii) The cost of telecast rights of films are amortized on straight-line basis over 60 months or license period whichever is shorter, from its first telecast.

**Content – Audio Rights / Recorded Cassettes, Compact Discs, etc.**

a) Copyrights of Audio titles acquired and recorded cassettes, compact discs produced for sale;

   i) Film based rights : 50% of cost expensed on audio release and balance after six months of film release or when cost is recouped, whichever is earlier.

   ii) Non-film based rights : 50% of cost expensed on audio release and balance after six months of release or when cost is recouped, whichever is earlier.

b) Recorded Audit Cassettes, Compact Discs : Cost means cost of production excluding cost of Audio Rights.

5. **Infosys Technologies Limited (31-3-04)**

**Revenue recognition**

Revenue from software development on fixed-price, fixed-time frame contracts is recognized as per the proportionate-completion method. On time-and-materials contracts, revenue is recognized as the related services are rendered. Annual Technical Services revenue and revenue from fixed-price maintenance contracts are recognized proportionately over the period in which services are rendered. Revenue from the sale of user licenses for software applications is recognized on transfer of the title in the user license, except in multiple arrangement contracts, where revenue is recognized as per the proportionate-completion method.

*Note : Infosys does not show any inventory in its financial statement.*